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SUBJECT: Natural Disasters Increase Short-Term Inflation

REF: A) QUITO 225, B) Quito 55 C) 07 Quito 2659, D) Quito 36, E) 07 Quito 2114, F) 07 Quito 2095

¶1. Summary. Ecuador's inflation rose in the first two months of 2008 due in large part natural disasters, namely severe flooding and a volcanic eruption. Additionally, rising global inflationary pressure, particularly for food, contributed to Ecuador's inflationary up-tick. However, Ecuador's medium- to long-term inflation outlook appears stable, although salary increases and rising government expenditure could generate inflationary pressure. End Summary.

Short Term Inflation Rise Due to Local Disasters
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¶2. (U) Inflation rose significantly in the first two months of 2008 compared to 2007. Inflation rose 1.14 percent in January 2008, the highest monthly increase in five years. Inflation rose 0.94 percent in February 2008 compared to 0.07 percent in February 2007. Annualized inflation through January 2008 was 4.19 percent, compared to 2.68 percent in the same period a year earlier.

¶3. (U) The eruptions of Tungurahua volcano in late January and early February affected agricultural production and distribution in the volcano's vicinity. Potato production was most significantly affected, with prices rising 3.8 percent in February 2008.

¶4. (U) Mass flooding throughout Ecuador in February harmed agricultural production, especially in coastal regions, and closed many transportation routes, thus hindering distribution (reftel a). This led to increased consumer prices nationwide. The largest inflationary spikes were seen in food products and non-alcoholic drinks. Prices in this group rose 0.52 percent in February 2008. Products with the highest increase were: tomatoes, 13.9 percent; fresh fish, 7.25 percent; and soft drinks, 3.8 percent.

¶5. (U) In addition to the weather and the volcanic eruption, two policy factors also contributed to inflation. The minimum wage was increased by 15% in late 2007 and was effective at the beginning of
¶2008. In addition, the government implemented extensive tax reforms at the beginning of the year (reftels b and c), including raising excise taxes on ostensibly luxury goods (including cigarettes, make-up and cars), which led to price increases for those goods.

Rising Global Inflationary Pressure

¶6. (U) Increasing global prices for commodities coupled with Ecuador's reliance on imported inputs have contributed to inflationary pressure on both consumer and producer prices since the middle of 2007. The biggest increases in February in this category were whole chickens, 6.6 percent; and vegetable oil, 5.4 percent; chicken prices are heavily influenced by the cost of imported feeds and other inputs, while vegetable oil is imported. Producer prices

rose 1.89 percent in February 2008, raising the annual producer prices inflation rate to 9.36 percent. With producer prices rising faster than consumer prices, this trend could put additional pressure on consumer prices.

¶7. (U) Rising petroleum prices have only a secondary impact on inflation in Ecuador, for example in the cost of plastic packaging material or international shipping costs. However, the domestic prices of fuel products (gasoline, diesel, LPG) have been frozen for several years. This policy, which predates the Correa administration, has become increasingly expensive for the government, which imports petroleum derivatives and subsidizes the difference.

Long Term Inflation Outlook Appears Stable

¶7. (U) At 3.3 percent, Ecuador's 2007 year-end inflation was the lowest in Latin America. In spite of the unexpected short term up tick from natural disasters, Ecuadorian inflation in the beginning of 2008 remained on par relative to its regional neighbors. In February 2008, Ecuador's inflation rate of 0.94 percent was lower than Colombia (1.51 percent) and equal to Peru (0.91 percent).

¶8. (U) The Central Bank of Ecuador predicts inflation to rise between 2.9 and 3.7% in 2008. Five-year predictions from the Economist Intelligence Unit predict Ecuadorian annual inflation rates between 3.4 and 4.5 percent through 2012.

Comment

¶11. (SBU) Since adopting the U.S. dollar in late 2000, inflation has been a bright spot in the Ecuadorian economy. Inflation rates have remained low both by regional and global standards. Although Ecuador had the lowest inflation rate in 2007 in Latin America and the medium- to long-term inflation outlook appears stable, risks remain. One is that short-term inflationary pressures remain from both the flooding and global price increases. It remains to be seen whether the government will try to contain this inflationary pressure through market intervention, as it has already done for milk (price controls), flour (subsidies), and rice (export ban) (reftels d-f).

¶12. (SBU) In the medium-term, continued government spending and promises of more wage hikes in upcoming years could generate additional inflationary pressure, although those pressures appear to be contained for the time being because of Ecuador's sluggish economic growth. Frozen fuel prices also represent suppressed inflation, which will be a problem when and if the government ever decides to adjust those prices.

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